

In a case of first impression, Tax Court holds that Rev. Proc. 99-32 accounts receivable constitute debt for Section 965 purposes

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In brief

Addressing the issue for the first time, the Tax Court has held in *BMC Software Inc. v. Commissioner*, 141 T.C. No. 5 (Sept. 18, 2013), that an account receivable established under Rev. Proc. 99-32 may constitute increased related-party indebtedness for purposes of the Section 965(b)(3) related-party debt rule. Under that rule, the amount qualifying for the one-time Section 965 dividends received deduction (DRD) is reduced by increased related-party indebtedness.

While narrowly addressing the interpretation of Section 965, the court's decision regarding the appropriate federal income tax treatment of accounts receivable established under Rev. Proc. 99-32 represents an important case of first impression affecting taxpayers electing such treatment for cash repatriations resulting from transfer pricing adjustments. The decision also could have important implications regarding other Code sections for taxpayers that elect Rev. Proc. 99-32 treatment. The decision therefore should be of substantial interest to all US multinational entities.

In detail

Factual and legal background

The taxpayer, BMC Software (BMC), is a US corporation that develops and licenses computer software. It collaboratively developed software with a wholly owned foreign subsidiary pursuant to cost-sharing agreements.

When the cost-sharing agreements were terminated and BMC reacquired software

rights from the foreign subsidiary, BMC agreed to pay royalties to the foreign subsidiary. The IRS determined that those royalty payments were not arm's-length. To resolve the dispute, BMC and the IRS entered into a closing agreement on August 30, 2007, under which BMC's income was increased by various amounts for the years at issue, 2003-2006 (these increases are known as the primary adjustments).

BMC elected to apply Rev. Proc. 99-32 to effect a cash repatriation of these transfer pricing adjustments. In general, Rev. Proc. 99-32 is a tax relief mechanism that allows taxpayers to establish an account receivable for the amount of a transfer pricing adjustment, and to receive payment of that receivable without further tax consequences (although interest is required to be accrued on the account receivable). This

mechanism is designed to allow a taxpayer to receive cash payments that conform to the income amount the taxpayer is reporting for tax purposes as a result of the transfer pricing adjustment.

This mechanism also allows the taxpayer to avoid the potential collateral tax consequences of “secondary adjustments” that might otherwise arise from a primary transfer pricing adjustment. “Secondary adjustments” are deemed cash transfers (in the form of deemed distributions or deemed capital contributions) made to conform the parties’ cash accounts to the transfer pricing result recognized for tax purposes.

Absent Rev. Proc. 99-32 treatment, the secondary adjustments in BMC’s case would have resulted in deemed capital contributions from BMC to the foreign subsidiary for US federal income tax purposes; however, the Rev. Proc. 99-32 treatment that BMC elected permitted it to establish accounts receivable for repayment from the foreign subsidiary to BMC. Accordingly, on August 30, 2007, BMC and the IRS also entered into a second closing agreement establishing interest-bearing accounts receivable from the foreign subsidiary to BMC. The amounts of the accounts receivable corresponded to the primary adjustments for each of the years at issue, including one for \$21 million deemed established on March 31, 2005, and another for \$22 million deemed established on March 31, 2006. (BMC’s tax years ended on March 31.) Pursuant to the revenue procedure’s mandate, the foreign subsidiary repaid the principal and interest within 90 days of the closing agreement becoming effective.

The last two years of the period covered by BMC’s transfer pricing adjustments — 2005-2006 —

coincided with BMC’s period of eligibility for the one-time Section 965 repatriation incentive. Section 965 permitted a US company in one tax year during BMC’s 2005-2006 tax years to receive CFC dividends qualifying for a DRD that reduced the US federal income tax rate on those dividends by 85%.

Congress enacted Section 965 in 2004 as an incentive for US companies to repatriate foreign earnings that foreign subsidiaries were holding outside the United States due to the high cost of paying dividends at the usual 35% US federal income tax rate. The dividends would be eligible for the reduced rate only to the extent that they met certain requirements. Among other conditions, Section 965(b)(3) required companies to deduct from the eligible dividend amount the amount of any increase in aggregate related-party indebtedness (RPI) from October 3, 2004, to the year-end of the elected Section 965 tax year (the testing period).

During the tax year ending March 31, 2006, BMC received \$721 million in repatriated funds from the foreign subsidiary and claimed that \$709 million of the \$721 million qualified for the one-time Section 965 DRD. The IRS determined that \$43 million did not qualify for the DRD, because the accounts receivable deemed established during the testing period constituted increased RPI, thereby reducing the amount qualifying for the DRD. In Notice 2005-64, section 10.06, the IRS had declared that it would treat Rev. Proc. 99-32 accounts receivable as RPI for purposes of Section 965(b)(3). The IRS did not issue regulations under Section 965; only this and two other Notices.

Tax Court decision

Treatment of Rev. Proc. 99-32 accounts receivable

The court first concluded that accounts receivable established under Rev. Proc. 99-32 may constitute “indebtedness” for section 965 purposes, based on “general Federal income tax principles” and the dictionary definition of indebtedness. The court noted that the revenue procedure’s requirements for accounts receivable, and BMC’s treatment of the accounts, are consistent with the dictionary definition of account receivable as “an account reflecting a balance owed by the debtor.” The court did not mention the position that the IRS took in Notice 2005-64.

The court then turned to BMC’s argument that the accounts receivable, even if indebtedness, should be exempt from Section 965(b)(3) because they are “trade payables.” Under Notices 2005-38 and 2005-64, indebtedness is excluded under the trade payables exception if it arises in the ordinary course of business and is actually paid within 183 days.

The court rejected the taxpayer’s argument, concluding that (1) the accounts receivable were created because of a section 482 adjustment, not in the ordinary course of business, and (2) the indebtedness was repaid more than one year after the date on which each account was deemed established.

Having determined that the accounts receivable created indebtedness from the foreign subsidiary to BMC, the court then had to determine whether that indebtedness arose during the testing period.

The court concluded that, because the second closing agreement provided that two of the accounts receivable

were deemed to have been established during the testing period, those accounts constitute increased indebtedness during the testing period. Consequently the court decided that the IRS properly reduced the amount of BMC's DRD by the amounts of those two accounts. The court apparently relied on the closing agreement provision stating that each account was deemed established as of the last day of the tax year for which the Section 482 adjustment was made, consistent with Rev. Proc. 99-32.

Federal tax consequences of the accounts receivable

The Tax Court also had to determine the meaning of the provision in the second closing agreement that the payment of the accounts receivable would be "free of the Federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment. ..." BMC argued that this provision precluded *any* further federal income tax consequences resulting from the repayment, meaning the accounts receivable should be excluded from determining the amount of the DRD.

The court disagreed with BMC's position, citing its 1978 decision in *Schering Corp. v. Commissioner*, in which the court analyzed an account receivable established under Rev. Proc. 65-17 – the predecessor to Rev. Proc. 99-32. The court concluded that the second closing agreement did not preclude all collateral tax consequences flowing from the receivable. Further, again citing *Schering*, the court rejected BMC's position that the election under Rev. Proc. 99-32 allows for inconsistent characterizations for Federal tax purposes (i.e., treating the receivable as debt for some purposes but not for other purposes). Instead, the court concluded that BMC avoided the consequences of the potential secondary adjustments by electing to

establish accounts receivable for all federal income tax purposes.

The court thus agreed with the IRS that the terms of the closing agreement relieved BMC of the tax consequences that would have resulted absent BMC's election to establish the accounts receivable, but did not extend this reasoning to limit other federal tax consequences resulting from the treatment of the accounts receivable for Rev. Proc. 99-32 purposes. The court found it significant that the closing agreement stated that the repayment, not the accounts receivable themselves, would be free of the tax consequences that otherwise would result from the primary adjustment.

Therefore, the court concluded, the second closing agreement did not preclude reduction of the DRD by the amounts of the accounts receivable deemed established during the testing period.

Issues raised by the court's decision

The Tax Court's decision in *BMC Software* raises a variety of issues.

First, it is widely recognized that an account receivable established under Rev. Proc. 99-32 is established solely for US federal income tax purposes. Courts generally are reluctant to extend legal fictions beyond their specific role in the relevant legal regime. The Tax Court in *Schering*, for example, allowed the taxpayer to claim a foreign tax credit for withholding taxes levied by a foreign country on a payment made to satisfy a Rev. Proc. 65-17 receivable, recognizing that the payment was actually made in the form of a dividend (subject to withholding) notwithstanding its treatment as a deemed payment of the account receivable for US tax purposes.

The *Schering* court reasoned that Rev. Proc. 65-17 was merely an

administrative mechanism intended to facilitate the repatriation of transfer pricing adjustments and that this mechanism was "not intended to determine any collateral tax consequences disadvantageous to petitioner which might ensue upon the payment of that sum." Thus, although the court in *BMC* cited *Schering* to support its decision to recognize disadvantageous collateral consequences arising from a Rev. Proc. 99-32 receivable, some of the reasoning in *Schering* might appear to support the opposite conclusion.

Second, the court's determination that the debt created by the accounts receivable existed during the testing period rested solely on the closing agreement term providing that each account is deemed established as of a specific date (the last day of the tax year for which the primary section 482 adjustment was made), consistent with Rev. Proc. 99-32. The opinion did not address, for example, whether significance should be ascribed to the fact no legal obligation to pay any indebtedness actually existed between the parties on these dates, or the principle that transfer pricing adjustments themselves do not give rise to payment obligations between the parties engaged in the controlled transactions.

No account receivable or other payment obligation arises from a transfer pricing adjustment unless a taxpayer makes the election to apply Rev. Proc. 99-32. Even if a receivable is considered indebtedness for all federal income tax purposes, therefore, a question arises whether this debt can exist before the taxpayer chooses to create the receivable through execution of a closing agreement electing the application of Rev. Proc. 99-32. In analyzing this issue, it might be considered whether the rule identifying the date a receivable is deemed established under Rev. Proc. 99-32 is intended

only to ensure that appropriate interest on the receivable is recognized from that date, rather than to create other tax consequences.

Third, in concluding that the debt was not a trade payable, the court pointed to the fact that the receivable was created as a result of a section 482 adjustment. The opinion did not consider whether the character of the receivable for this purpose should flow from the underlying transaction that gave rise to the pricing adjustment and resulting receivable.

Fourth, the policies of both Rev. Proc. 99-32 and Section 965 are relevant considerations. Both Section 965 and Rev. Proc. 99-32 are intended to benefit taxpayers. Specifically, the administrative procedure in Rev. Proc. 99-32 is a relief mechanism designed to facilitate resolution of transfer pricing disputes by allowing cash repatriations to conform taxpayer accounts to the transfer pricing results. The policy purpose behind Section 965 was to encourage foreign

earnings repatriations. The provision reducing the Section 965 DRD by certain RPI was designed primarily to prevent taxpayers from “round-tripping” funds from the US to a CFC via a loan and then back to the US via a Section 965 dividend; such practice, it was thought, was inconsistent with the intended repatriation incentive. A Rev. Proc. 99-32 receivable established as a result of a transfer pricing examination, under a revenue procedure designed to facilitate resolution of transfer pricing disputes, may not be within the scope of the concern that prompted the RPI rule in Section 965. Consequently, a relevant consideration is whether treating a Rev. Proc. 99-32 receivable as RPI for Section 965 purposes might undermine the benefits intended by both regimes.

The takeaway

This case will be of particular concern for companies that took advantage of the Section 965 repatriation incentive and also took (or plan to take)

advantage of Rev. Proc. 99-32. In general, the practice of establishing and paying Rev. Proc. 99-32 receivables is becoming more common as taxpayers’ transfer pricing arrangements are subject to increasingly intense scrutiny and adjustment by the IRS and other tax authorities. Rev. Proc. 99-32 receivables can be established both with respect to IRS-initiated adjustments (as a result of an examination), and to reflect a self-initiated transfer pricing adjustment that the taxpayer reports on its tax return.

In either case, the Tax Court’s decision in *BMC Software* has potential implications. When deciding whether to establish a Rev. Proc. 99-32 receivable as a result of an examination adjustment or a self-initiated adjustment, taxpayers should consider the potential tax consequences of treating the receivable as if it were true indebtedness outstanding from the end of the relevant tax year.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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